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**ALEXANDER L. STEVENS,
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(6)
No. 84-165

**In The
Supreme Court of the United States
October Term, 1984**

—○—
W. GEORGE GOULD,

Petitioner,

VS.

MAX A. RUEFENACHT, et al.,

Respondents.

—○—
**ON PETITION FOR WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT**

—○—
BRIEF OF RESPONDENT

—○—
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COUNTER STATEMENT OF QUESTION PRESENTED

Is the purchase of fifty percent of the shares of stock of a closely held corporation by one who participates in the affairs of the corporation the purchase of "securities" within the meaning of the federal securities laws?

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BRIEF OF RESPONDENT

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STATEMENT OF THE CASE

In the spring of 1980, respondent, Max A. Ruefenacht (Ruefenacht), was approached by Joachim Birkle (Birkle) to invest in a corporation known as Continental Import & Export, Inc. (Continental), a New Jersey corporation engaged principally in the importation of wine,

spirits and mineral water into the United States and the wholesale sale thereof. The investment was to take the form of a purchase by Ruefenacht of one-half of Continental's stock (J.A.52a).

At the time that Birkle first approached Ruefenacht all of the outstanding stock of Continental was held by Birkle, his wife Elizabeth Birkle, and Lenzenhof GmbH (Lenzenhof), a corporation owned by the Birkle family (J.A.25a). Birkle maintained absolute management authority over Continental, subject only to a Board of Directors consisting of Birkle, petitioner George Gould (Gould) and, at various other times, other individuals who served at Birkle's pleasure. At all times, Birkle dominated the operations of the Board of Directors and the activities of Continental (R.185a).¹

As an incentive to entice Ruefenacht to purchase one-half of the shares of stock of Continental, Birkle and Gould, acting on behalf of Continental, gave Ruefenacht financial statements, prospectuses, *pro forma* balance sheets and various other documents. This documentation was geared to make the financial position of Continental appear extremely bright and to portray the company as richly endowed with assets. By way of example, the documents purported to demonstrate that Continental had import contract rights worth \$400,000, goodwill and licenses

¹As used herein R. shall refer the record of the district court as certified to the court of appeals. The pagination shall be the same as utilized in the appendix filed with the court of appeals.

worth \$250,000, total assets of over \$838,000 and total equity of over \$792,000 (J.A.28a).

Gould is, and at all times in question has been, an attorney licensed to practice law in the State of New Jersey and functioned both as corporate counsel to Continental and as a director of that corporation (J.A.26a). In these capacities he prepared and passed upon, a directors' resolution establishing the values assigned to the import contract rights and the goodwill and licensed indicated above (J.A.29a). Gould submitted that resolution to Christopher J. O'Halloran (O'Halloran),² a certified public accountant who prepared the financial statements on behalf of Continental (J.A.25a-26a).

Ruefenacht alleges that the representations made in those documents as well as other statements constituted material misrepresentations of fact. Further, it is alleged that the various defendants omitted to state material facts necessary to make the facts contained in the documents and oral statements not misleading (J.A.28a-36a).

In reliance upon the misrepresentations, and in ignorance of the omitted facts, Ruefenacht agreed to invest \$250,000 in Continental to be used for working capital by buying 2500 shares of its common stock at \$100 per share (J.A.46a). After Ruefenacht had paid an initial \$120,000 in connection with the stock purchase, he learned of the false nature of the representations made (R.182a). Ac-

²O'Halloran is a defendant in this action, and a respondent on this appeal.

cordingly, he sought to rescind the transaction and obtain return of his money, which the defendants refused to do. Based upon the foregoing circumstances, Ruefenacht instituted this action (J.A.27a).

At no time did Ruefenacht intend to, nor did he, participate to any significant extent in the daily management of the business affairs of Continental. (R.183a). On the contrary, at all times Ruefenacht was a full time employee of Autobern Trading Corporation (Autobern), an exporter of American automobiles³ (J.A. 53a). Ruefenacht's association with Continental was in the capacity of an investor and not as a manager or an employee. In fact, Ruefenacht never received any compensation in the form of salary or otherwise for any actions which he may have undertaken on behalf of Continental (R.186a).

At no time did Ruefenacht intend to take over the actual management of Continental or otherwise absolutely direct or control its operations. While it was his desire to help Continental in any way possible so as to enhance the value of his investment, it was always the intention of the parties that Birkle would run the business (R.184a).

Although it has been contended that Ruefenacht did undertake to perform certain functions for Continental (Pb3-4) (which he never has denied), nowhere in any of the facts presented is there any evidence that he intended to control, manage or run the business, or even work in it on a day-to-day basis. The most that can be said is as follows:

³Autobern was brought in as a third party defendant in this action by Gould.

1. Ruefenacht intended to become a director of Continental, although he never did in fact become one and never attended any directors' meetings (J.A.53a).

2. Ruefenacht met with some salesmen of Continental and discussed the hiring of one salesman with Birkle (J.A.54a).

3. Ruefenacht signed a banking resolution denominating himself as an officer of the corporation, which resolution was prepared for the purposes of permitting him to sign checks because Birkle was contemplating a trip out of the country and would be unavailable to do so (J.A.53a).

4. Ruefenacht signed an application for a liquor license (a solicitor's permit) (J.A.47a).

5. While on his summer vacation in Europe in 1980 Ruefenacht visited several potential vendors for Continental (J.A.54a).

6. On one occasion Ruefenacht asked Gould to expedite a liquor license for which Gould was applying in his capacity as attorney for Continental (J.A.55a).

7. On at least one occasion Ruefenacht visited certain warehouses with Birkle (J.A.55a).

The suit instituted by Ruefenacht seeks damages and, in the alternative, rescission for violations of Sections 12(1), 12(2) and 17(a) of the Securities Act of 1933 (the 1933 Act), 15 U.S.C. § 77(1)(1)-(2), 77(q)(a) (1982); Section 10(b) of the Securities Exchange Act of 1934 (the 1934 Act), 15 U.S.C. § 78(j)(b); and Rule 10b-5 of the Securities and Exchange Commission promulgated thereunder, 17 C.F.R. § 240.10b-5 (1984). Ruefenacht also al-

leged pendent state law claims for fraud, negligence and breach of fiduciary duties.

Gould filed a motion for summary judgment seeking to dismiss all federal securities law claims on the grounds that the shares of stock purchased by Ruefenacht were not "securities" within the definition of the federal securities laws. The motion further sought to dismiss the balance of the complaint based upon lack of federal jurisdiction. After the motion was denied without prejudice, (J.A.45a) limited discovery was undertaken respecting the extent of control which Ruefenacht intended to assert over the affairs of Continental⁴. At the conclusion of discovery, an evidentiary hearing was held at which time the Magistrate determined:

Based upon the foregoing findings of fact it is concluded that Ruefenacht intended to purchase a 50%

⁴At the time that it denied Gould's initial application for summary judgment without prejudice, the trial court established the following guidelines:

He [Mr. Ruefenacht] did not have total control, owning only 50% of the stock, and he was not in control of the day-to-day activities, although he did participate in some of them. Although Ruefenacht contributed his talents and efforts to Continental's pursuit of business and profits, it has not been shown that his goal was to control the entire business. If he was not in overall control, the Court must conclude that the efforts of those who were running the business, such as Birkle, were to be the primary source of profits realized on Ruefenacht's investment. As such the investment would meet the test for a security, and the transaction would be governed by the federal laws. A hearing is necessary to resolve these questions. The Court will retain jurisdiction over both the federal and pended [sic] State claims, and defendants' motion is DENIED without prejudice to their right to renew upon the submission of all proofs. (Emphasis supplied by Court). (J.A.50a).

ownership of the shares of stock of Continental and to exercise all that control to which a 50% owner is entitled. It has not been shown that there was any possible way that Ruefenacht could have exerted more control. His actions were at all times subject to the absolute veto power of his partner, Mr. Birkle. The actions of the parties are consistent with the equality of control and joint participation in the business of the corporation is clearly demonstrated by the evidence presented. There is no evidence to the contrary. (J.A.56a).

Upon a review of the Magistrate's findings, the district court granted summary judgment in favor of all defendants. Accepting the validity of the so-called "sale of business doctrine", the district court ruled:

The trend of the law is to apply the 'economic reality' test to purchases of less than all of the company's stock to determine whether the purchaser would actively manage his investment. Because Mr. Ruefenacht intended to jointly manage Continental with Mr. Birkle, he did not purchase 'securities' as defined in the federal acts. (J.A.62a).

In its discretion, the court dismissed all pendent state law claims pursuant to *United Mine Workers v. Gibbs*, 383 U.S. 715 (1966).

On Ruefenacht's appeal, the Court of Appeals for the Third Circuit reversed, holding that no economic analysis of the transaction in which Ruefenacht participated was appropriate and that "[t]he sale of all or part of a business effectuated by the transfer of stock bearing the traditional incidents of stock ownership is the sale of a 'security' under the 1933 and 1934 Acts." *Ruefenacht v. O'Halloran*, 737 F.2d 320, 339 (3d Cir. 1984).

SUMMARY OF ARGUMENT

I

The applicability of the federal securities laws to the case at bar is mandated by the clear and unambiguous language of the definitional sections of the relevant statutes. The instruments purchased by the respondent contain all of the attributes normally associated with shares of stock. As the term security by definition includes stock, the decision of the Court of Appeals for the Third Circuit should be affirmed.

The doctrine espoused by petitioner, that one who purchases a "controlling" interest in a business in which he invests is afforded no remedy under the securities acts, is not supported by either the statutes' language or their legislative history. Rather, the statutes, while explicitly exempting from coverage certain instruments, were designed to afford protection to all purchasers of stock, whether of public or private corporations and regardless of whether the purchaser was a passive investor or businessman active in the corporation's affairs.

II

In an unbroken line of decisions, this Court has upheld the principle that purchasers of traditional shares of stock are afforded the protection of the federal securities laws. While the Court has created various tests to determine whether this protection should be extended to various novel and exotic types of instruments, such tests never have been utilized to determine the applicability of the statutes to instruments that clearly fall under any of the specifically enumerated types of instruments that are definitionally securities.

III

Adoption of petitioner's position would create great uncertainty as to whether a transaction was governed by the federal securities laws. Further, purchasers of stock need the protection offered by the securities acts and have come to rely upon the existence of this protection to supplement any common law remedies that might exist. Most importantly, adoption of the doctrine urged by the petitioner would lead to wholly inequitable and arbitrary results.

POINT I

Traditional Stock Is A Security Within The Meaning Of The Federal Securities Laws Regardless Of The Economic Context Of The Transaction.

A. The Plain Meaning Of The Statutory Language Requires That The Federal Securities Laws Be Applied To The Transaction In Question.

The thrust of petitioner's argument is that the Court should not apply the federal securities laws "to transactions within the statutes' letter but not their spirit" (Pb7). Confronted with a statute which in unambiguous language clearly requires application to the case at bar, petitioner would have this Court disregard long-established rules of statutory interpretation that require adherence to the plain meaning of a statute's text. *Richards v. United States*, 369 U.S. 1, 9 (1961). Rather, petitioner urges the Court to embrace a doctrine derived not from the language of the statute, but from a twisted view of legislative history.

Faced with a similar argument, the Court in *Ex Parte Collett*, 337 U.S. 55, 61 (1949), set aside such distorted views of statutory interpretation, stating:

The short answer is that there is no need to refer to the legislative history where the statutory language is clear. 'The plain words and meaning of a statute cannot be overcome by a legislative history which, through strained processes of deduction from events of wholly ambiguous significance, may furnish dubious bases for inference in every direction.' *Gemsco v. Walling*, 1945, 324 U.S. 244, 260, 65 S.Ct. 605, 614, 89 L.Ed. 921. This canon of construction has received consistent adherence in our decisions.

Any exercise in statutory interpretation must begin with an examination of the statutory language itself. *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 558 (1979). Utilizing definitional sections that are virtually identical, Congress defined "security" in both the 1933 and 1934 Acts as any of fourteen separately listed types of instruments as well as any instrument "commonly known as a 'security'". 15 U.S.C. § 78c(a)(10). Included in this descriptive list of what constitutes a "security" is the term "stock" which has been categorized rightly as the "paradigm of a security", *Daily v. Morgan*, 701 F.2d 496, 500 (5th Cir. 1983), and "so quinessentially a security as to foreclose further analysis", L. Loss, *Fundamentals Of Securities Regulation*, 212 (1983).

In its first examination of the statute in question, this Court had little problem with the term "stock":

In the Securities Act the term 'security' was defined to include by name or description many documents in which there is common trading for speculation or investment. *Some, such as notes, bonds, and stocks, are pretty much standardized and the name alone carries well settled meaning.* Others are of more variable character and were necessarily designated by more descriptive terms, such as 'transferable share', 'investment contract', and 'in general any interest or instru-

ment commonly known as a security.' We cannot read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents. *Instruments may be included within any of these definitions, as matter of law, if on their face they answer to the name or description.* (Emphasis added).

S.E.C. v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).

In the case *sub judice* there is no question that respondent Ruefenacht purchased shares of stock, nor is there any question that the district court was correct in determining that the shares in question have all of the "traditional" attributes of stock.⁵ Accordingly, giving effect to the ordinary meaning of the language of the statutes, Ruefenacht's stock must be deemed to be a "security" and the transactions in question subject to the provisions of the 1933 and 1934 Acts. As was noted by the Court in *Joiner*, 320 U.S. at 355:

⁵The district court observed:

In the present case the stock which Ruefenacht received contains all the attributes mentioned by the Forman Court [*United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851 (1975)] as indicating that the transaction did involve a security. (J.A.50a).

See also, *Ruefenacht v. O'Halloran*, 737 F.2d at 338. It should be noted that the stock in question was free of any restrictions at the time of its initial issue, but was later made subject to certain restrictions on transferability pursuant to a shareholders agreement (R. 238a-269a). Such restrictions are common among shareholders in a closely held corporation and in New Jersey where Continental was incorporated, statutorily permissible to the extent that they do not unreasonably restrict transfer. N.J. Stat. Ann. § 14A:7-12 (West 1984). Accordingly, Ruefenacht's shares were transferable subject to certain restrictions. Further, transactions involving the stock of closely held corporations are clearly within the purview of the securities acts. *Thomas v. Duralite Co.*, 524 F.2d 577 (3d Cir. 1975).

In the present case we do nothing to the words of the Act; we merely accept them. It would be necessary in any case for any kind of relief to prove that documents being sold were securities under the Act. In some cases it might be done by proving the document itself, which on its face would be a note, a bond, or a share of stock.

This construction follows long accepted principles of statutory interpretation. The term "stock" is one of a series of terms which are alternate examples of the defined term, security:

In construing the statute we are obligated to give effect, if possible, to every word Congress used. *United States v. Menasche*, 348 U.S. 528, 538-539 (1955). Canons of construction ordinarily suggest that terms connected by a disjunctive be given separate meanings unless the context dictates otherwise; . . .

Reiter v. Sonotone Corp., 442 U.S. 330, 339 (1978).

Once a court determines that the instrument in question is traditional stock or one of the other types of instruments specifically enumerated in the definition of "security", the inquiry into the applicability of the federal securities laws is at an end. Only when dealing with an exotic or difficult to categorize instrument is it necessary to consider the applicability of more general terms, such as "investment contract". *Joiner*, 320 U.S. at 351; *Tcherpnin v. Knight*, 389 U.S. 332, 342 (1967).

Decisions upholding the sale of business doctrine, which hold that the general term "investment contract" circumscribes the scope of specific terms such as "stock", e.g., *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982), result in rendering virtually all of the definitional language of the statute superfluous. If Congress had intended to de-

fine "security" simply within the parameters of "investment contract" it easily could have done so. The use of a listing of fourteen alternate descriptive terms to define security requires that each of those terms be given separate meaning. *McDonald v. Thompson*, 305 U.S. 263, 266 (1938). Any other reading would render the listing of specific categories of security a mere redundancy in violation of settled principles of statutory interpretation *Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 307-308 (1961).

B. Neither The "Context" Clause Nor Legislative History Supports An Interpretation Which Would Disregard The Plain Meaning Of The Securities Statutes.

Only under rare and exceptional circumstances will a court override the literal terms of the statute. *Crooks v. Harrelson*, 282 U.S. 55, 60 (1930). Departures from the letter of the law are permitted only in those situations in which a literal reading would result in an "absurdity . . . so gross as to shock the general moral or common sense." *Id.* In this case, however, petitioner does not contend that a literal application of the statute to the case at bar would lead to an absurd result. Rather, he bases his position upon an unsupportable construction of the "context" clause and an examination of legislative history through rose-colored glasses.

1. The phrase "unless the context otherwise requires" prefacing the definition of "security" refers to the statutory context, not the economic context of the transaction in which the instrument is used: The definition of a security in both the 1933 and 1934 Acts begins with the prefaced language "[w]hen used in this subchapter, unless the context otherwise requires—". Where logic would

dictate that the phrase "the context" refers to the context of the statute itself, petitioner uses the phrase as a spring board to argue that before applying the federal securities laws a court must consider the factual and economic context of the transaction in question. The legislative history of the term "security" clearly points to the opposite conclusion.

The "context" clause precedes all definitions contained in the statutes in question as well as numerous other federal statutes. In the past this Court has interpreted the phrase to require the judiciary to consider the meaning of words in the context of the *particular statute* under consideration. *S.E.C. v. National Securities*, 993 U.S. 453, 466 (1969):

Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and 1934 Acts preface their lists of general definitions with the phrase 'unless the context otherwise requires'.

Any other result leaves unexplained the question of why the context clause was used to modify all the definitions of both the 1933 and 1934 Acts and not limited to those instruments that are subject to economic transactions. The context clause modifies, *inter alia*, the term "territory" in the 1933 Act, 15 U.S.C. § 77b(6), and the term "records" in the 1934 Act, 15 U.S.C. § 78c(37). It is difficult to conceive of any factual or economic situation which would have to be examined in order to determine whether Puerto Rico was a territory or whether books of account constituted a record.

Nor does the legislative history support the illogical argument of petitioner. As examined in detail by the court

of appeals below, *Ruefenacht*, 737 F.2d at 330-32, the Senate version of the 1933 Act contained the phrase "unless the *text* otherwise indicates," H.R. 5480, 73d Cong. 1st Sess. 39 (1933) (as enacted by the Senate May 10, 1933); S.875, 73d Cong., 1st Sess. 1 (1933), while an early House version of the bill containing identical language was modified to state "unless the *context* otherwise requires". See H.R. 5480, 73d Cong., 1st Sess. § 1 (1933) (as enacted by the House on May 5, 1933). A conference committee ultimately chose the House version without any indication of the reasons for that decision. *H. Conf. Rep. No. 152*, 73d Cong., 1st Sess. 24-25 (1933). The lack of any legislative history forces the conclusion that Congress expected judicial scrutiny to be limited to a consideration of the context of the particular statute in which a defined term might be used and not leave open the door for a wide ranging exploration of the underlying factual and economic context of the transaction in question. *Exchange National Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1138 (2d Cir. 1976).

2. *The sale of business doctrine finds no support in legislative history:* Finding no support in the language of the statutes themselves petitioner seeks to avoid their plain meaning by contending that legislative history demonstrates that Congress could not have meant what it said because (at least in petitioner's opinion) it was interested in protecting passive investors as opposed to those who took a more active role in the affairs of the corporation in which they invested.

Any inquiry into legislative history of the definitional section must begin with the report of the House Committee On Interstate And Foreign Commerce. In sum-

marizing the provisions of the proposed 1933 Act, the report states:

Paragraph (1) defines the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.

H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933).

The failure to specifically define the term "stock" in the statute leads to the conclusion that Congress intended that that word be construed in accordance with its ordinary everyday meaning. *Russello v. United States*, 104 S.Ct. 296, 299 (1983). The concept that some stock sales, e.g., when control of a corporation is being transferred, would not be subject to coverage under the securities laws is nowhere to be found within the House report. In fact, the committee clearly stated the desire to regulate sales in which a controlling group of shareholders seeks to sell its interest in a corporation:

All the outstanding stock of a particular corporation may be owned by one individual or a select group of individuals. At some future date they wish to dispose of their holdings and to make an offer of their stock to the public. Such a public offering may possess all the dangers attendant upon a new offering of securities.

H.R. Rep. No. 85, 73d Cong., 1st Sess. 13-14 (1933).

Furthermore, the 1933 Act contains specific sections under which certain types of securities are exempted, 15 U.S.C. § 77c, and certain securities transactions are not subject to the registration provisions of the statute, 15 U.S.C. § 77d. However, within this scheme even the sale of securities that are exempt from the statute's registration requirements are still subject to the anti-fraud pro-

visions, 15 U.S.C. § 77q(c). Neither petitioner nor any of the courts that have espoused the sale of business doctrine have made any attempt to explain why Congress would go to such pains to explicitly exempt certain types of securities transactions from the registration requirements while at the same time silently or by some vague inference removing transactions such as that between the parties in the case at bar entirely from the coverage of the securities laws. Furthermore, no explanation is offered why Congress in enacting the Williams Act, 15 U.S.C. § 78n, would utilize the definition of security found in 15 U.S.C. § 78c(10), although that legislation was specifically designed to regulate tender offers seeking control of corporations.

Undoubtedly, the statutes in question were designed in order to provide protection to investors. But there is no evidence in the legislative history that that protection was limited to those purchasers of stock who did not take an active role in the business in question:

While investor protection was a constant preoccupation of the legislators, the record is also replete with references to the desire to protect ethical businessmen. See 77 Cong. Rec. 2925 (1933) (remarks of Rep. Kelly); *Id.*, at 2983 (remarks of Sen. Fletcher); *Id.*, at 3232 (remarks of Sen. Norbeck); S. Rep. No. 47, 73d Cong. 1st Sess. 1 (1933). As Representative Chapman stated, '[t]his legislation is designed to protect not only the investing public but at the same time to protect honest corporate business.' 77 Cong. Rec. 2935 (1933). Respondent's assertion that Congress' concern was limited to investors is thus manifestly inconsistent with the legislative history.

United States v. Naftalin, 441 U.S. 768, 776 (1979).

Thus the sale of business doctrine finds no support either in the statutory text or in the legislative history. Petitioner's argument is no more than a plea for this Court to rewrite the federal securities laws so that he may avoid judicial scrutiny of his misdeeds. Dismissing similar arguments in the past, this Court has noted:

Had Congress intended so fundamental a distinction, it would have expressed that intent clearly in the statutory language or the legislative history. It did not do so, however, and it is not this Court's function to 'sit as a super Legislature,' *Griswold v. Connecticut*, 381 U.S. 479, 482 (1965), and create statutory distinctions where none were intended.

American Tobacco v. Patterson, 456 U.S. 63, 72 n.6. (1982).

POINT II

Precedent Of This Court Sustains The Conclusion That The Purchase Of Shares Stock Of Continental By Ruefenacht Constituted The Purchase Of "Securities"

Petitioner's analysis of Supreme Court precedent (Pb15-Pb19) utterly fails to deal with the fact that this Court has never held shares of traditional stock not to be a security. The Court has dealt with a number of cases arising under the federal securities statutes in the fifty years since their enactment. Not once in any of those decisions which involved instruments possessing the attributes of traditional stock has the Court ever embarked upon a preliminary analysis of the transaction before applying the relevant law in such cases. Rather, consideration of the economic circumstances of the exchange trans-

action has been limited to novel or uncommon instruments that do not fall within any of the specifically enumerated categories of "security".

The petitioner contends that the sale of business doctrine was "explicitly" adopted by this Court in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (Pb17). In fact *Forman* does not provide support for that dubious doctrine. Rather, that decision and those which have followed it specifically undercut any such theory.

In *Forman*, plaintiffs contended that they had been induced by certain misrepresentations to purchase what were referred to as "shares of stock" in state-subsidized cooperative apartments known as "Co-Op City". They brought actions under the federal securities laws for rescission and damages. The Court, in a two part opinion, first rejected plaintiffs' argument that the shares in a cooperative apartment complex constituted securities within the meaning of the 1934 Act, 15 U.S.C. § 78c(a)(10), ruling that the mere labeling of interests as "stock" did not invoke the antifraud protection afforded by federal law.

We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called 'stock', must be considered a security transaction simply because the statutory definition of a security includes the words 'any . . . stock'. 421 U.S. at 848.

In making that statement, however, this Court did not conclude that a transaction which involved traditional stock (such as the shares which Ruefenacht purchased) was not a securities transaction, but rather, was differentiating stock in the traditional sense from an interest

which was not in fact stock, although labeled as such. In fact, the Court noted:

There may be occasions when the use of a traditional name such as 'stocks' or 'bonds' will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument. 421 U.S. at 850-851.

In determining that the tenants' interest in the co-operative apartments was not stock in the traditional sense, this Court observed:

These shares have none of the characteristics 'that in our commercial world would fall within the ordinary concept of a security.' (Citation omitted). Despite their name, they lack what the court in *Tcherepnin* deemed the most common feature of stock: the right to received 'dividends contingent upon an apportionment of profits' (citation omitted). Nor do they possess the other characteristics traditionally associated with stock: they are not negotiable; they cannot be pledged or hypothecated; they confer no voting rights in proportion to the number of shares owned; and they cannot appreciate in value. In short, the inducement to purchase was solely to acquire subsidized low cost living space; it was not to invest for profit. 421 U.S. at 851.

In short, the first part of *Forman* (part II, A) constituted a finding by this Court not that actual, traditional stock such as that purchased by Ruefenacht was not a security, but rather, that the shares in the co-op were not "stock". In contrast, the shares of stock purchased by Ruefenacht have all of those attributes the *Forman* Court found normally associated with traditional stock. Had the Court in *Forman* been faced with the issue posed

in the case *sub judice*, it undoubtedly would have ended the inquiry at this point and held that the federal securities laws were applicable in conformance with *S.E.C. v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 355 (1943).

Having determined that the shares of the co-op were not "stock", and therefore not automatically securities as a matter of definition, the Court in *Forman* dealt with the plaintiffs' alternative argument that the instrument which was issued and sold constituted an investment contract, another type of security listed in the definition. *Forman*, 421 U.S. at 851-58 (part II, B). This Court restated the test for determining the existence of an investment contract as: "'whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.'" *Forman*, 421 U.S. at 852 (quoting *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946)). Based upon the *Howey* criteria, this Court found that no investment contract was present because the co-operative was a non-profit venture and therefore failed to meet the second part of the three part *Howey* test, i.e., a profit motive. *Id.* at 301. This Court applied the *Howey* test, however, only after determining that the shares were not traditional stock.

Quite clearly then, if an instrument specifically named and defined as a security carries the traditional attributes of that instrument, nothing more is necessary to qualify under the 1933 and 1934 Acts. It is only when the instrument in question, or the transaction itself if there is no specific instrument, does not fall into any of the specifically delineated categories that a test must be invoked to determine whether it falls within a general catch-all cate-

gory such as "investment contract". Petitioner's suggestion that the catch-all terms should be construed as modifiers of the specific terms requiring application of the *Howey* test to all instruments flies in the face of *Joiner*, 320 U.S. 344, 350 (1943), and *Tcherepnin v. Knight*, 389 U.S. 332, 343 (1967). See also Note, *Repudiating The Sale-Of-Business Doctrine*, 83 Colum. L.Rev. 1718, 1732 n.106 (1983). As Professor Loss has observed:

It is one thing to say that the typical cooperative apartment dweller has bought a home, not a security; or that not every installment purchase 'note' is a security; or that a person who charges a restaurant meal by signing his credit card slip is not selling a security even though his signature is an 'evidence of indebtedness.' But *stock* (except for the residential wrinkle) is so quintessentially a security as to foreclose further analysis. (Emphasis in original).

L. Loss, *Fundamentals of Securities Registration*, 212 (1983).

This Court has consistently resorted to the *Howey* test in determining whether an investment contract exists only in those transactions which dealt with unusual or unconventional instruments which did not fall into any of the specific definitional categories.⁶ Respondent's analysis

⁶*Tcherepnin*, 389 U.S. 332 (involving withdrawable capital shares of a savings and loan association); *S.E.C. v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967), (involving combined variable fixed annuities); *S.E.C. v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959), (involving variable annuity contract); *Howey*, 328 U.S. 293 (involving the sale of citrus acreage coupled with optional service contracts to cultivate crops); *Joiner*, 320 U.S. 344 (involving sales of assignments of oil leases); *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979) (involving a non-contributory, compulsory pension plan).

of Supreme Court precedent as set forth above, is hardly novel. It accords with decisions in four courts of appeal in addition to that under appeal here and various commentators. *Coffin v. Polishing Machines, Inc.*, 596 F.2d 1202 (4th Cir. 1979), *cert. denied*, 444 U.S. 868 (1979); *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982); *Seagrave Corp. v. Vista Resources, Inc.*, 696 F.2d 227 (2d Cir. 1982), *cert. granted*, 104 S.Ct. 2341 (1984), *cert. dismissed*, 105 S.Ct. 23 (1984); *Daily v. Morgan*, 701 F.2d 496 (5th Cir. 1983); *Cole v. PPG Industries, Inc.*, 680 F.2d 549 (8th Cir. 1982); Note, *Repudiating The Sale-Of-Business Doctrine*, 83 Colum. L.Rev. 1718, 1732 n.106 (1983); Carson, *Applications Of The Federal Securities Acts To The Sale Of A Closely Held Corporation By Stock Transfer*, 36 Me. L.Rev. 1, 23-38 (1984).

As petitioner contends, there is a contrary view expressed by four circuits. This view, known as the sale of business doctrine was first defined in *Fredericksen v. Poloway*, 637 F.2d 1147 (7th Cir. 1981), *cert. denied*, 451 U.S. 1017 (1981). The Seventh Circuit held that under *Forman* when the purchase of stock actually involves the purchase and assumption of control of an entire business, the transaction does not involve a "security" within the meaning of the federal securities laws. This was based on the assertion that the "economic reality" of the transaction is commercial, the acquisition of the business with the intent to manage, rather than investment. The Seventh Circuit continued that view in *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981), and *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1981). Recently, however, while not specifically disclaiming allegiance to *Sutter*, that

same circuit in *Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984) observed:

Of the two points RBC maintains are correct, the weakest one appears to be the point that every instrument must independently pass the investment contract test in order to be a security, RBC's principal support for this point is a single statement in *Forman* to the effect that the investment contract test 'embodies the essential attributes that run through all the Court's decisions defining a security.' In this statement, however, the Court merely identified a characteristic of its past decisions, all of which involved an unusual instrument not easily placed within the ambit of the other terms enumerated in the definitional sections of the securities acts. . . . An additional reason militates against the finding that the investment contract criteria apply to all securities. In *Forman* itself the Court initially considered whether respondents' shares could be 'stock' as the term is used in Section 2(1) of the Securities Act of 1933. In this section of the opinion, the court did not apply the investment contract test. Only after the court rejected respondents' characterization of their shares as 'stock' did the court look to the investment contract test. The implication that follows from the organization of the court's opinion is that the test articulated in *Howey* only determines whether an instrument is an 'investment contract,' a separate statutory term in the definitional section of the securities acts; an instrument that does not pass the investment contract test may still be a security if it falls under one of the other specific statutory terms. 745 F.2d at 491.

The court further states:

The investment contract test determines whether a particular instrument is an 'investment contract,' a distinct term in the definitional sections of the securities act. An instrument that fails to satisfy all four requirements of the investment contract test may still

fall under one of the other statutory terms in the definitional section and hence be subject to the substantive provisions of the acts. 745 F.2d at 492.

As observed even by the Seventh Circuit in *Hunssinger* those circuits which have adopted the sale of business doctrine confuse the two part nature of *Forman* and, for some reason, apply the *Howey* test to traditional shares of stock. In doing so, they conclude that unless the purchaser of stock acquires it with the intent that he achieve profits from the efforts of others, his stock somehow is not really a security.

By way of example, *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982), involved the sale of all of the stock of a corporation. The Eleventh Circuit observed that "the stock transferred in this case clearly has all the characteristics that fit the ordinary conception of a security". 673 F.2d at 344. Rather than abiding by the first part of the *Forman* test, and concluding that the stock was a security within the meaning of the federal securities laws, the court turned to the second half of the *Forman* opinion observing:

Based on the rationale of *Forman*, we reject a literal test and hold that the 'economic realities' test is appropriate to determine whether a transaction involving stock in a corporation is a 'security transaction' or an 'investment contract' governed by the Federal Securities Acts.

673 F.2d at 344-345.

The fallacy of this argument is that traditional stock is not, nor need it be, an investment contract. They are two separate things. The fact that one of the elements

of an investment contract was absent in *Winkler* is wholly irrelevant. Since the instrument qualified as a security under the first part of the *Forman* test by being traditional stock, there was no need to fall back on the investment contract theory as the plaintiffs were forced to do in *Forman*.

Recently, this Court again followed the procedure first laid down in *Joiner* and followed through *Tcherepnin*, *Forman* and *Daniel*. In *Marine Bank v. Weaver*, 455 U.S. 551 (1982), the plaintiffs guaranteed a bank loan and pledged a certificate of deposit as collateral for the guarantee. As consideration, the borrowers gave the plaintiffs the right to receive a percentage of the profits of the business owned by them, the right to use a barn and pasture belonging to the business and the right to veto future loans made to the borrowers. The plaintiffs contended that the bank fraudulently induced them to enter into the transaction and that that fraud constituted a violation of the federal securities laws. This Court was called upon to determine whether the certificate of deposit was a "security" or, alternatively, whether the private agreement between the plaintiff and the borrowers was a "security".

In arriving at its decision that no security was involved, the Court followed the same two step test it had enunciated in *Forman*. First, it examined the statutory definition of a security and observed that while the term "certificate of deposit" was not found therein, there were other instruments named to which the certificate of deposit might be equivalent. In so doing, the Court clearly and unambiguously observed that the statutory definition

specifically "includes ordinary stocks and bonds, along with the 'countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.'" 455 U.S. at 556 (quoting *Howey*, 328 U.S. at 299). The Court went on to observe that if the certificate of deposit was the equivalent of any of the specifically named instruments, it would *automatically* qualify as a security 455 U.S. at 557-58.

Examining the instrument before it, the Court determined that the certificate of deposit was not, in fact, the same as any of the items specifically identified by the Act as securities, including, for example, a certificate of deposit for a security, a long term debt obligation, or withdrawable capital shares of a savings and loan association which the court observed "were much more like ordinary shares of stock and 'the ordinary concept of a security'" 455 U.S. at 557.

Having concluded that the certificate of deposit could not be equated with any of the specifically enumerated items which would automatically qualify it as a security (nowhere does the three part "economic reality" test rear its head in the first part of the *Weaver* decision), the Court embarked upon the second part of the two-part *Forman* test to deal with the plaintiffs' alternate contention that the agreement between him and the borrowers might be a "certificate of interest or participation in a profit sharing agreement" or an "investment contract" 455 U.S. at 599. Here, for the first time, the Court applied the *Howey* test and found on the basis of that test, that this particular agreement did not fall within the definition of either an investment contract or a profit sharing agreement. Ac-

cordingly, the agreement could not qualify as a security under any of the definitions of the 1934 Act.⁷

Ruefenacht's stock clearly carries the traditional attributes of that instrument. The shares entitled him to dividends contingent upon the apportionment of profits, *Tcherepnin*, 389 U.S. at 359, voting rights and all "other characteristics traditionally associated with stock". *Forman*, 421 U.S. at 851. In these circumstances, the precedent of this Court does not require, nor does it permit, the Court to look behind the name of the instrument specified in the statute.

POINT III

Policy Considerations Favor The Rejection Of The Sale Of Business Doctrine.

A. Uncertainty Of Application Requires The Rejection Of The Sale Of Business Doctrine.

One of the least attractive aspects of the sale of business doctrine is the difficulty, if not impossibility of defining and predicting its application. Petitioner insists that before the securities acts can be applied to any exchange of stock there first must be an analysis under the test established for investment contracts in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946), to determine whether "the scheme involves an investment of money in a common

⁷An additional factor was also involved in the Supreme Court's consideration of both of *Daniel* and *Weaver*. In *Daniel*, the Court reasoned that ERISA supplanted any necessity for coverage by the securities acts 439 U.S. at 569-70. The Court expanded on this theme in *Weaver*, holding that because the FDIC insured the certificate of deposit the FDIC supplanted any necessity for coverage under the securities laws. 455 U.S. at 558. No such regulatory schemes, however, apply in the sale of business context.

enterprise with profits to come solely from the efforts of others." *Id.* at 301. Determining whether the profits come "from the efforts of others" requires an evaluation of something called "control" in each instance. Whether control refers to intended control, exercised control or control which one is capable of exercising in any particular set of circumstances is not clear, nor has petitioner clearly articulated what control is to mean.

The suggestion by petitioner that "corporate control in a securities law context means the ability to influence corporate direction or policy" (Pb26 n. 12) is hardly helpful. Every shareholder in every corporation has some ability to influence corporate direction or policy. Even those who are not shareholders but who are employees of a corporation or, for that matter, people who are not associated with the corporation directly such as competitors, have the ability to influence the policy of the corporation.

Assuming that the type of control petitioner and other proponents of the sale of business doctrine require is some substantial degree of control, it is an arduous, if not impossible, task to define or predict what that control will be in any given transaction involving the exchange of stock. Ruefenacht's situation provides an example of the dilemma. Continental is a New Jersey corporation, and as such its affairs are governed by the statutory law of the State of New Jersey, specifically N.J. Stat. Ann. §14A:1-1 *et seq.* (West 1984). Under New Jersey law "the business and affairs of the corporation shall be managed by its Board [of Directors] . . ." N.J. Stat. Ann. §14A:6-1. At no time was Ruefenacht entitled to be more than one member of what was authorized to be a six-person

board and, as a result, was never entitled to more than one vote out of six. Further, even if a new board were elected, at best he could elect half of the board. The most he could do with half of the board would be to force a deadlock. N.J. Stat. Ann. § 14:A:12-7.⁸ In short, as a 50% shareholder Ruefenacht could exercise no degree of control other than the ability to block the other 50% shareholder from acting unilaterally.

The suggestion by petitioner that there is nothing arbitrary or unpredictable about the application of the sale of business doctrine is absurd. He suggests that a hearing be held in each case to evaluate standards which have never been articulated and which probably are not capable of being articulated clearly (Pb29-Pb30). By way of example only, query: How does one define control then? How is it evaluated in a corporation utilizing staggered directorships? In a corporation where the purchaser has the ability to elect a new board of directors at some time in the future, does he have control? When does he acquire that control? What is the standard of control in corporations with cumulative voting or class voting? How do the super-majority voting provisions of certain state statutes effect the issue of "control"? Far from reduc-

⁸Pursuant to New Jersey law a director cannot be removed prior to the expiration of his scheduled term absent a showing of good cause or absent a provision to the contrary in the Certificate of Incorporation. Nothing in the record in this case indicates any such provision in Continental's Certificate of Incorporation. N.J. Stat. Ann. § 14A:6-6. Even a removal for cause, however, requires the affirmative vote of a majority of the votes cast by the shareholders. Therefore, Ruefenacht could not even remove a director for cause without the acquiescence of Birkle.

⁹See e.g., Delaware law: Del. Code Ann. Tit. 8 § 102(b) (4) (1984) and *Atlantic Properties, Inc. v. Commissioner*, 519 F.2d 1233 (1st Cir. 1975).

ing the amount of Federal litigation as petitioner suggests the application of the sale of business doctrine will significantly increase the burden on the courts. In publicly traded corporations, holdings of far less than 50% of the outstanding stock may provide a certain ability to "control" depending upon the definition given to control. How is this factored into the equation? See e.g., *Essex Universal Corp. v. Yates*, 305 F.2d 572, 578-79 (2d Cir. 1962).

Beyond the issue of control is the artificial and further complicating issue of the "investor-entrepreneur" dichotomy in the sale of business doctrine. The application of that portion of the *Howey* test requiring that profits be derived from the efforts of others necessitates making a distinction between intent to invest and intent to manage, a line that cannot be easily drawn in terms of when the intent derives or changes, how much participation is permitted, etc. Nor is there any justification for suggesting that a person is less entitled to protection under the federal securities acts because he undertakes to perform services on behalf of the corporation for the purposes of protecting or enhancing the value of his investment. See *Ruefenacht v. O'Halloran*, 737 F.2d 320, 334 (3d Cir. 1984); Note, *Repudiating The Sale-Of-Business Doctrine*, 83 Colum. L.Rev. 1718, 1738-39 (1983). Further, any doctrine which turns on intent faces the problem that the intent of the purchaser may change either during or after the stock transaction. Since the questions of control and intent cannot be answered in the abstract and are not susceptible to a single hard definitional rule every case would involve a mini (or perhaps maxi) trial on those issues.

Finally, any doctrine which suggests that securities law coverage is not provided to one who acquires traditional stock with the intent to manage or control of necessity excludes from the reach of the anti-fraud provisions of the federal securities laws most if not all tender offer battles. When U.S. Steel purchased Marathon Oil the "economic reality" was that U.S. Steel would control, in fact dominate, the operation of the enterprise. Under the economic reality test this would not be a securities transaction. Surely such a result is not consistent either with the letter or spirit of the 1933 or 1934 Acts.

B. Special Risks Inherent In The Purchase Of Stock Dictate That Purchasers Of Stock Be Accorded The Protection Of The Federal Securities Laws.

Petitioner suggests that there is no need for the federal securities laws to provide protection to those who acquire controlling interests in a corporation because "as plaintiff-purchasers become increasingly able to protect themselves through control or influence over the enterprise, and concomitantly less dependent upon others for a return of profit, such persons progressively become less in need of securities law protection and hence less reason exists to extend coverage to them." (Pb27). Such a position ignores the fact that the damage from a fraudulent sale of stock occurs at the time the transaction occurs, before the purchaser takes "control".

Customarily, one who acquires the assets of a corporation but not its liabilities can shield himself from liability to the corporation's creditors. Such protection is not available to one who acquires the stock of a corporation

since the entity remains subject to its liabilities. The need for federal securities law protection is particularly acute when, as the Fifth Circuit observed in *Daily v. Morgan*, 701 F.2d 496, 502 (5th Cir. 1983):

[T]here are special risks involved in the sale of stock in a corporation that might justify special protection. Generally speaking, one who purchases the assets of a business is not liable for its debts and liabilities, while one who purchases the stock in a corporation—a separate legal entity—assumes ownership of a business with both assets and liabilities [citations omitted]. Liabilities, alas, are often the subject of inaccurate or incomplete disclosures.

701 F.2d at 504. See also *Ruefenacht*, 737 F.2d at 333.

While, of course, it is possible for a purchaser of a "controlling" interest in a corporation to reduce certain risks by employing attorneys and accountants to comb through every detail and aspect of the seller's business, such an investigation is costly and even the best, most expensive audit is susceptible to the deception of the seller. Further, there exists no justification to impose the economic burden of such examinations and investigations on an investor who acquires "control", and not upon one who does not. Certainly it may be possible to acquire "control" of one corporation in a transaction involving the purchase of stock for \$10,000 and not to acquire "control" when purchasing one million dollars' or more worth of stock in another corporation. Accordingly, any suggestion that there are more dollars at stake in an acquisition involving control is fallacious.

C. The Employment Of The Sale Of Business Doctrine Would Deprive A Purchaser Of Stock Of The Justifiable Expectations And Benefit Of His Bargain.

By choosing to deal in the transfer of stock as opposed to a sale of assets, the parties operated under the presumption that the federal securities laws should apply. As this Court observed in *United States Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 850-51 (1975):

There may be occasions when the use of a traditional name such as 'stocks' or 'bonds' will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

Thus, the reliance of the buyer and his attorney upon the understanding that the anti-fraud provisions of the federal securities laws will protect them is justified, particularly where the stock purchased exhibited the characteristics of traditional stock such as those purchased by Ruefenacht. Accepting petitioner's view would eliminate the protection for which the parties bargained from the purview of the statute.

D. The Anti-Fraud Provisions Of The Federal Securities Laws Are Intended To Provide Protection To Purchasers Of All Securities, Whether Or Not Registered.

The language of the very anti-fraud provisions of the federal securities laws under which Ruefenacht seeks redress evinces an intention to protect purchasers of unregistered as well as registered securities. Section 10(b) of the 1934 Act prohibits the use of manipulative or deceptive devices "in connection with the purchase or sale of any security registered on a national securities ex-

change or any security not so registered. . . ." (Emphasis added) 15 U.S.C. §78j(b). Certainly, if Congress had intended to exempt the sale of controlling interests in closely held corporations from the anti-fraud provisions it could have done so. Congress was able to exempt many securities transactions from other requirements of the securities laws when it chose to, but mandated that the anti-fraud provisions of Sections 10(b) of the 1934 Act and 12(2) of the 1933 Act apply to private as well as public securities transactions. Clearly, the purpose of the federal securities laws is to protect purchasers of all securities, not just those in publicly traded corporations. This Court set any contrary argument to rest more than a decade ago when it stated:

. . . we do not read Section 10(b) as narrowly as the Court of Appeals; it is not 'limited to preserving the integrity of the securities markets' (430 F.2d at 361), though that purpose is included. Section 10(b) must be read flexibly, not technically and restrictively.

* * *

. . . we read Section 10(b) to mean that Congress wanted to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face.

Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

Courts which support the sale of business doctrine seek to confine the protection of the securities laws to shareholders of publicly traded corporations in spite of the specific language of *Bankers Life*. See e.g., *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982) and petitioner's brief at 26-27. As Professor Loss has observed, "one difficulty

with the negative view in the sale-of-business case is that it comes dangerously close to the heresy of saying that the fraud provisions do not apply to private transactions;" L. Loss, *Fundamentals of Securities Regulation*, 212 (1983).

E. The Existence Of State Law Protection Should Not Justify The Adoption Of The Sale Of Business Doctrine.

The suggestion that the purchaser or seller of shares constituting a "controlling interest" in a corporation should not require protection of the federal securities laws because there are state remedies for fraud does not justify the adoption of the sale of business doctrine.

The argument that common law remedies are adequate to protect a purchaser simply is not true. For example, the seller may not be solvent and it may not be possible for the purchaser to proceed under state law against all possible defendants because of the existence of privity requirements under state, but not federal, securities laws.

Additionally, there is nothing in the federal securities laws which suggests that they apply only in the absence of an adequate common law remedy. Quite the contrary, the 1933 Act explicitly states: "The rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. §77p.¹⁰ Further, this Court has

¹⁰See Note, *Repudiating The Sale-Of-Business Doctrine*, 83 Colum. L.Rev. 1718, 1739 n. 152, 1742 (1983) as to additional benefits conferred on victims of fraud by the securities acts.

always emphasized the remedial characteristics of the federal securities laws. See *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

Accordingly, there is no justification to suggest that the adequacy of a state remedy serves as a justification for the adoption of the sale of business doctrine.

F. The Adoption Of The Sale Of Business Doctrine Would Create Unfair And Arbitrary Distinctions.

A rule which directs that a defrauded purchaser of 51% of the stock of a corporation has no federal remedy, whereas his partner who acquired 49% has such a remedy, is unfair, unreasonable and arbitrary. It makes no sense that the sale of all of a corporation's stock to a single buyer by a single seller constitutes the sale of a security but the same sale to a single buyer by several sellers, each of whom did not formally exercise control, does not.¹¹ Further, it makes no sense that a series of stock sales each in and of itself insufficient to transfer control from a single seller to a single purchaser constitutes the sale of securities, but that the final sale (that which pushes the purchaser over the level of "control", whatever that level may be) does not. Clearly there was no greater or less fraud in connection with the sale to the 51% partner than there was in the 49% transaction, nor was the fraud any more monstrous in the tenth sale to the same purchaser than it was in the first nine.

¹¹*McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 467 n.5 (7th Cir. 1981), cert. denied, 454 U.S. 835 (1981).

There is no justification for telling a defrauded purchaser that he has no federal remedy merely because he participated in the operation of the business, whereas if he had been a passive investor he would have had a cause of action for the very same fraud. If such were the law, no employee purchasing stock of a corporation by which he is employed would be protected under the federal securities laws.

In *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982), the court in explanation of its adherence to the sale of business doctrine, discussed the difference between a "investor", whom the securities laws would protect, and "entrepreneur" who would not have that benefit:

There is a clear difference in principle between an investor and an entrepreneur; and while sometimes a person is both at once, often he is one or the other. A judge who owns IBM stock is an investor but not an entrepreneur; the corner grocer is a food entrepreneur rather than an investor in the food business, though a conglomerate corporation that owned a chain of grocery stores might be both.

687 F.2d at 201. What is the standard of fairness that provides the billion-dollar conglomerate which purchases the stock of a "mom and pop" grocery store with the protection of the federal securities laws, but denies that protection to the same mom and pop who purchase a store from the conglomerate? And what is to happen to "investors" who become "participants" after the purchase takes place?

The sale of business doctrine would require making arbitrary distinctions which would impute a chameleon-like quality to stock unintended by Congress. The un-

predictability and arbitrariness which the doctrine would inflict on the commercial world must be avoided.

CONCLUSION

For all of the foregoing reasons it is respectfully requested that the decision of the Court of Appeals for the Third Circuit to reverse the dismissal of the respondent's federal securities laws claims be affirmed.

Respectfully submitted,

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